

TAB 28

ACC Section 10,640

Statement of Position 94-6 Disclosure of Certain Significant Risks and Uncertainties

December 30, 1994

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. [Statement on Auditing Standards No. 69](#), *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by [Rule 203](#) of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

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The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the *Report of the Task Force on Risks and Uncertainties* (the Report), which was intended to help standards-setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This statement of position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

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The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

Scope

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This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements. While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. ^{fn.1} If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

.04

The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations, proposed changes in accounting principles, ^{fn.2} or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements

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The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as [FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies](#), and, for public business enterprises, [FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise](#). ^{fn.*} The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

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Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

Definitions

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This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See [paragraph .21.](#)) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, ^{fn.3} yet they may not be so significant as to disrupt

the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic. ^{fn 4}

Conclusions

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The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

- a. Nature of operations
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

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The following detailed discussion of the four areas of disclosure enumerated in [paragraph .08](#) should be read in conjunction with the "Illustrative Disclosures" in appendix A [[paragraph .27](#)] of this SOP, which provide guidance for implementing them.

Nature of Operations

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Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination—for example, assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as *predominately*, *about equally*, or *major and other*. ^{fn 5}

Use of Estimates in the Preparation of Financial Statements

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Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

Certain Significant Estimates

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Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, [paragraphs 9](#) through [12](#), and [17b](#), and footnote 6 of [FASB Statement No. 5](#) specify disclosures to be made about contingencies ^{fn.6} that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in [FASB Interpretation No. 14](#), *Reasonable Estimation of the Amount of a Loss*. In addition to disclosures required by [FASB Statement No. 5](#) and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

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Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

- a. It is at least reasonably possible ^{fn.7} that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

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The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible ^{fn.8} that a change in the estimate will occur in the near term. ^{fn.9} If the estimate involves a loss contingency covered by [FASB Statement No. 5](#), the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

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Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in [paragraph .13](#) are not met as a result of risk-reduction techniques, the disclosures described in [paragraph .14](#) and disclosure of the risk-reduction techniques are encouraged but not required.

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This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of [FASB Statement No. 5](#); rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by [FASB Statement No. 5](#)) meets the criteria for disclosure under [paragraph .13](#) of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; [FASB Statement No. 5](#) does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in [paragraph .13](#). This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

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Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

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The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations

- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

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[Paragraph 5 of FASB Statement No. 121](#), *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, ^{fn.1} provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed. ^{fn.10} [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Current Vulnerability Due to Certain Concentrations

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Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

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Financial statements should disclose the concentrations described in [paragraph .22](#) if, based on information known to management prior to issuance of the financial statements, *all* of the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

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Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of [paragraph .21](#). (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

- a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.* The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
- b. *Concentrations in revenue from particular products, services, or fund-raising events.* The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- c. *Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.* The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- d. *Concentrations in the market or geographic area ^(in 11) in which an entity conducts its operations.* The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

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Concentrations of financial instruments, and other concentrations not described in [paragraph .22](#), are not addressed in this SOP. However, these other concentrations may be required to be disclosed pursuant to other authoritative pronouncements, such as [FASB Statement No. 107](#), *Disclosures About Fair Value of Financial Instruments*, ^(in 11) as amended by [FASB Statement No. 126](#), *Exemption From Certain Required Disclosures About Financial Instruments for Certain Nonpublic Entities*. [Revised, June 2004, to reflect conforming changes necessary to reflect the issuance of FASB Statement No. 133, as amended by [FASB Statements No. 137](#), [No. 138](#), and [No. 149](#).]

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Disclosure of concentrations meeting the criteria of [paragraph .21](#) should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor ([paragraph .22c](#)) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country ([paragraph .22d](#)) that meet the criteria of [paragraph .21](#), the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the

percentage of the labor force covered by a collective bargaining agreement that will expire within one year.

- For operations located outside the entity's home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with [FASB Statement No. 131](#). In accordance with [paragraph .08](#) of this SOP, such information need not be repeated. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of [FASB Statement No. 131](#). ^{fn #}]

Application of Disclosure Criteria

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An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events. For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP's requirements if an appropriate judgment had been made that a near-term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

Effective Date

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This SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required.

Appendix A

Illustrative Disclosures

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	<u>Contents</u>	<u>Paragraph Numbers</u>
Nature of Operations		